

Letter of Findings Number: 08-0298 & 08-0297R
Sales and Use Tax
For the Tax Years 2003-2005

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ISSUES

I. Sales and Use Tax—Manufacturing Exemptions.

Authority: IC § 6-2.5-1-10; IC § 6-2.5-3-2; IC § 6-2.5-3-4; IC § 6-2.5-5-3; IC § 6-2.5-5-5.1; [45 IAC 2.2-5-8](#); [45 IAC 2.2-5-12](#); Indiana Dep't of State Revenue v. Kimball Int'l Inc., 520 N.E.2d 454 (Ind. Ct. App. 1988); Sales Tax Information Bulletin 69 (December 2002).

Taxpayer protests the imposition of use tax.

II. Sales and Use Tax—Labels and Labeling Equipment.

Authority: IC § 6-2.5-1-10; IC § 6-2.5-3-2; IC § 6-2.5-3-4; IC § 6-2.5-5-6; [45 IAC 2.2-5-14](#); Indiana Dep't of State Revenue v. Kimball Int'l Inc., 520 N.E.2d 454 (Ind. Ct. App. 1988).

Taxpayer protests the imposition of use tax.

III. Sales and Use Tax—Use Tax Paid in Error.

Authority: IC § 6-2.5-2-1; IC § 6-2.5-3-2; IC § 6-2.5-3-4; Indiana Dep't of State Revenue v. Kimball Int'l Inc., 520 N.E.2d 454 (Ind. Ct. App. 1988).

Taxpayer protests the imposition of use tax on certain of its purchases.

IV. Tax Administration—Penalty.

Authority: IC § 6-8.1-10-2.1.

Taxpayer protests the imposition of the ten percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is a manufacturer in Indiana. Taxpayer filed Indiana use tax returns for the 2003, 2004, and 2005 tax years. Taxpayer also filed refund requests for use tax paid during the 2003, 2004, and 2005 tax years. After an audit, the Indiana Department of Revenue ("Department") determined that Taxpayer owed additional sales and use tax for the tax years 2003, 2004, and 2005. The Department found that Taxpayer had made a variety of purchases on which the Indiana sales tax was not paid at the time of purchase nor was use tax remitted to the Department. Simultaneously, pursuant to an investigation, the Department denied a portion of Taxpayer's refund claims. Taxpayer protests the imposition of use tax on certain purchases in the audit findings and denials of refund. An administrative hearing was held, and this Letter of Findings results. Further facts will be provided as necessary.

I. Sales and Use Tax—Manufacturing Exemptions.

DISCUSSION

Indiana imposes "an excise tax, known as the use tax," on tangible personal property that is acquired in retail transactions and is stored, used, or consumed in Indiana. IC § 6-2.5-3-2(a). An exemption from the use tax is granted for transactions when sales tax was paid at the time of purchase pursuant to IC § 6-2.5-3-4. For the purchases, where Taxpayer failed to either pay sales tax at the time of the purchase or remit use tax, the Department assessed use tax. For the purchases, where Taxpayer had remitted use tax to the Department and claimed a refund, the Department denied the Taxpayer's claim for refund.

Taxpayer asserts that certain of its machinery, equipment, and supplies are exempt under the "manufacturing exemptions" found at IC § 6-2.5-5-3 (the equipment exemption) and IC § 6-2.5-5-5.1 (the consumption exemption).

The "equipment exemption" is found at IC § 6-2.5-5-3(b), which provides an exemption from sales and use tax for "manufacturing machinery, tools, and equipment... if the person acquiring the property acquires it for direct use in the direct production [or] manufacture... of other tangible personal property." IC § 6-2.5-5-3. Property acquired for "direct use in the direct production" is defined in [45 IAC 2.2-5-8\(c\)](#) as "manufacturing machinery, tools, and equipment to be directly used by the purchaser in the production process" that have "an immediate effect on the article being produced." Property has "an immediate effect" when it becomes "an essential and integral part of the integrated process which produces tangible personal property." [45 IAC 2.2-5-8\(c\)](#). [45 IAC 2.2-5-8\(d\)](#) excludes pre-production and post production activities by providing that "'direct use in the production process' begins at the point of first operation or activity constituting part of the integrated production process and ends at the point that the production has altered the item to its complete form."

The "consumption exemption" is found at IC § 6-2.5-5-5.1(b), which provides an exemption from sales and use tax for property "if the person acquiring the property acquires it for direct consumption as a material to be

consumed in the direct production of other tangible personal property in the person's business of manufacturing." Property obtained for "direct consumption as a material to be consumed in direct production" is further defined in [45 IAC 2.2-5-12\(c\)](#) as "materials [that] are directly used in the production process" and have "an immediate effect on the article being produced." Property has "an immediate effect" when it becomes "an essential and integral part of the integrated process which produces tangible personal property." [45 IAC 2.2-5-12\(c\)](#).

Accordingly, tangible personal property purchased for the direct use in the direct production of a manufactured good or for the direct consumption in the direct production of a manufactured good is subject to sales and use tax unless the property used has an immediate effect on and is essential to the production of the marketable good.

In applying any tax exemption, the general rule is that "tax exemptions are strictly construed in favor of taxation and against the exemption." *Indiana Dep't of State Revenue v. Kimball Int'l Inc.*, 520 N.E.2d 454, 456 (Ind. Ct. App. 1988).

A. "Proofing Inks."

The Department found that the "proofing inks" are used in pre-production activities, which [45 IAC 2.2-5-8\(d\)](#) excludes from the "manufacturing exemptions."

Taxpayer asserts that as a "commercial printer" its purchases of "proofing inks" are exempt from sales and use tax because the "proofing inks" are used in exempt "pre-press activities." Taxpayer maintains that since the "proofing inks" are used by Taxpayer's "graphic arts department" to design the "proofs," which the "plate-making department" uses to make the "printing plates," the "proofing inks" are used in "pre-press activities." Taxpayer cites to Sales Tax Information Bulletin 69 (December 2002) to support its assertion.

"Commercial printing" is defined at IC § 6-2.5-1-10, as follows:

"Commercial printing" means a process or an activity, or both, that is related to the production of printed materials for others, including the following:

- (1) Receiving, processing, moving, storing, and transmitting, either physically or electronically, copy elements and images to be reproduced.
- (2) Plate making or cylinder making.
- (3) Applying ink by one (1) or more processes, such as printing by letter press, lithography, gravure, screen, or digital means.
- (4) Casemaking and binding.
- (5) Assembling, packaging, and distributing printed materials.

The term does not include the business of photocopying.

While Taxpayer does perform some of these activities, Taxpayer is not in the business of commercial printing. Taxpayer is a manufacturer that happens to perform some similar activities to someone in the business of commercial printing within its manufacturing process. Nonetheless, even if Taxpayer were a commercial printer, Taxpayer's "proofing inks" would not be exempt from sales and use tax.

There is no regulation that sets out the Department's position regarding the application of the "manufacturing exemptions" for commercial printing activities, including "pre-press activities." However, the Department discusses the issue in Sales Tax Information Bulletin 69 (December 2002), which states, in its relevant part, as follows:

A commercial printer is, therefore, entitled to an exemption for machinery, tools and equipment that are directly used to perform a process or activity, or both, that is related to the production of printed materials for others. This includes equipment, (computers, scanners, etc.), that is used to perform what is commonly referred to as pre-press activities, which include the receiving, processing, moving, storing, and transmitting, either physically or electronically, of copy elements and images to be reproduced, and plate-making or cylinder-making. Exempt pre-press activities do not include drafting of copy or the creation of artwork for reproduction.

(Emphasis Added.)

While the Bulletin states that "pre-press activities" include "plate-making," it specifically states that "pre-press activities" do not include the "drafting of copy or the creation of artwork." Since "proofing inks" are used in the designing ("drafting" or "creating") of "proofs" ("copies" or "artworks"), the "proofing inks" are not "pre-press activities" and are not exempt from sales and use tax under the "manufacturing exemptions."

Therefore, for all the reasons provided above, Taxpayer's protest is denied.

B. "Flexo Washer."

The Department found that the "flexo washer" is used in the performance of general maintenance during times of pre-production and post production and is excluded from "the equipment exemption" found in IC § 6-2.5-5-3. See [45 IAC 2.2-5-8\(d\)](#) & (h)(1).

Taxpayer asserts that the "flexo washer" is machinery that is directly used in the direct production of printed materials and has an immediate effect on the printed materials as required in IC § 6-2.5-5-3. Taxpayer states that the "flexo washer" is used to clean "anilox rolls" during the production process. The "anilox rolls" are the part of the press that transfers the ink from the ink trays to the product. Taxpayer maintains that the cleaning of the "anilox rolls" is necessary to the production process to ensure that the quality of the print remains high and

consistent. Taxpayer states that cleaning does not interrupted the production process because when the dirty "anilox rolls" are removed from the press to be cleaned, ones that were previously cleaned are put into the press at that time. The exchanging of the "anilox rolls" takes approximately 10 to 15 minutes.

[45 IAC 2.2-5-8\(h\)\(1\)](#) excludes maintenance activities by providing that "[m]achinery, tools, and equipment used in the normal repair and maintenance of machinery used in the production process which are predominantly used to maintain production machinery are subject to tax." Also, [45 IAC 2.2-5-8\(d\)](#) excludes pre-production and post production activities by providing that "'direct use in the production process' begins at the point of first operation or activity constituting part of the integrated production process and ends at the point that the production has altered the item to its complete form."

Taxpayer has provided sufficient information to establish that the "flexo washer" is property used in the direct production of other tangible personal property at least part of the time. When the washing activities are performed during a particular job or production run, the washing is essential and integral to Taxpayer's production process and qualifies for the equipment exemption under IC § 6-2.5-5-3(b). However, when the washing activities are performed between jobs, between production runs, or at the end of the workday, the activities represent post-production maintenance activities as found in [45 IAC 2.2-5-8\(d\)](#) & (h). Therefore, the "flexo washer" does not qualify for the exemption, to the extent that it is used between jobs, between production runs, or at the end of the workday.

Taxpayer has failed to provide sufficient documentation that demonstrates the percentage of time that the "flexo washer" was used in each of these activities. Taxpayer will have 30 days from the issue date of this Letter of Findings to provide the documentation that shows the percentage of time that the "flexo washer" is used for each of the activities. Taxpayer's protest will be sustained, to the extent that it is able to provide sufficient documentation demonstrating the amount of time the "flexo washer" is used during a particular job or production run. However, Taxpayer's protest is denied, to the extent that the documentation reflects the "flexo washer" use between jobs, between production runs, or at the end of the workday.

Therefore, Taxpayer's protest is denied in part and sustained in part subject to the findings of a supplemental audit.

C. "Pails and Pail Liners."

The Department found that the "pails and pail liners" are used in pre-production activities, which [45 IAC 2.2-5-8\(d\)](#) excludes from the exemption. The Department determined that the "pails and pail liners" are used to transport ink prior to its entrance into the production process.

Taxpayer maintains that the "pails and pail liners" are directly used in the direct manufacturing of property and have an immediate effect on the product produced as required by IC § 6-2.5-5-3(b). Taxpayer states that the "pails and pail liners" are used by Taxpayer in its "ink department" to blend the ink and solvents and transport them to the presses where the operator of the press pours the ink mixture onto the press.

[45 IAC 2.2-5-8\(f\)\(3\)](#) states, "Transportation equipment used to transport work-in-process or semi-finished materials to or from storage is not subject to tax if the transportation is within the production process." Thus, if the "pails and pail liners" are first used to mix, alter, combine, or change the form of the ink before transportation, the "pails and pail liners" are used in the start of a production process. However, if the ink being transported in the "pails and pail liners" has not been mixed, altered, combined, or changed in form prior to the transport, the "pails and pail liners" simply function to transport a raw material before it enters into the manufacturing process.

While Taxpayer has provided sufficient information to establish that the "pails and pail liners" are property used in the direct production of other tangible personal property at least part of the time, Taxpayer has failed to provide sufficient documentation that demonstrates the percentage of time that the "pails and pail liners" were used in each of these activities. Taxpayer will have 30 days from the issue date of this Letter of Findings to provide the documentation that shows the percentage of time that the "pails and pail liners" are used for each of the activities. Taxpayer's protest will be sustained, to the extent that it is able to provide sufficient documentation demonstrating the amount of time the "pails and pail liners" were used to transport ink that has been mixed, altered, combined, or changed in form prior to the transport. However, Taxpayer's protest is denied, to the extent that the documentation reflects the transportation of ink that has not been mixed, altered, combined, or changed in form prior to the transport.

Therefore, Taxpayer's protest is denied in part and sustained in part subject to the findings of a supplemental audit.

D. Repair Parts.

The Department found that Taxpayer purchases of various sized "cap screws" were subject to sales and use tax.

Taxpayer asserts that the various sized "cap screws" were purchased to make repairs and are replacement parts, which are exempt from sales and use tax under [45 IAC 2.2-5-8\(h\)\(2\)](#). Taxpayer maintains that the "cap screws" were purchased to make repairs to the worn or broken "cap screws" on its "presses" and "extrusion machines."

Pursuant to [45 IAC 2.2-5-8\(h\)\(2\)](#) "[r]eplacement parts, used to replace worn, broken, inoperative, or missing parts or accessories on exempt machinery and equipment, are exempt from tax." Accordingly, a replacement part

purchased for the "presses" or "extrusion machine" would be exempt, to the extent that the "presses" or "extrusion machines" are exempt.

Therefore, Taxpayer's protest is sustained.

E. Worktable.

The Department found that Taxpayer's purchase of a worktable was subject to sales and use tax.

Taxpayer asserts that the worktable was purchased to perform quality control testing and inspections and is exempt from sales and use tax under [45 IAC 2.2-5-8\(i\)](#). Taxpayer maintains that the products are removed from the production line at regular intervals and inspected at the worktable to see if adjustments need to be made to the production process.

[45 IAC 2.2-5-8\(i\)](#) discusses an exemption for "testing and inspecting" that takes place during the production process and provides a helpful example, as follows:

Machinery, tools, and equipment used to test and inspect the product as part of the production process are exempt.

–EXAMPLE–

Selected parts are removed from production according to a schedule dictated by statistical sampling methods. Quality control equipment is used to test the parts in a room in the plant separate from the production line. Because of the functional interrelationship between the testing equipment and the machinery on the production line and because of the product flow, the testing equipment is an integral part of the integrated production process and is exempt.

Taxpayer has provided sufficient information to establish that the worktable is used for quality control testing and inspections during the production process and is exempt.

Therefore, Taxpayer's protest is sustained.

FINDING

In summary, Taxpayer's protest of subpart A is denied, and Taxpayer's protests of subparts D and E are sustained. Taxpayer's protests of subparts B and C are denied in part and sustained in part subject to the findings of a supplemental audit.

II. Sales and Use Tax—Labels and Labeling Equipment.

The Department found that Taxpayer purchases of certain labels and labeling equipment were subject to sales and use tax.

Indiana imposes "an excise tax, known as the use tax," on tangible personal property that is acquired in retail transactions and is stored, used, or consumed in Indiana. IC § 6-2.5-3-2(a). An exemption from the use tax is granted for transactions when sales tax was paid at the time of purchase pursuant to IC § 6-2.5-3-4. For the purchases, where Taxpayer failed to either pay sales tax at the time of the purchase or remit use tax, the Department assessed use tax. For the purchases, where Taxpayer had remitted use tax to the Department and claimed a refund, the Department denied the Taxpayer's claim for refund.

Taxpayer asserts that the labels are incorporated as a material part of its product and are exempt under IC § 6-2.5-5-6. Taxpayer maintains that since its customers require the labels and the labels contain some product information, the labels become part of the product.

IC § 6-2.5-5-6 provides an exemption from sales tax "if the person acquiring the property acquires it for incorporation as a material part of other tangible personal property which the purchaser manufactures... for sale in his business." Departmental regulation [45 IAC 2.2-5-14](#) states that in order to find that material is incorporated into the property produced for resale, "[t]he material must be physically incorporated into and become a component of the finished product, [t]he material must constitute a material or integral part of the finished product, and [t]he finished tangible personal property must be produced for sale by the purchaser." [45 IAC 2.2-5-14\(d\)](#).

In its protest, Taxpayer supports its assertions by citing to other taxpayers' Letters of Findings. Notwithstanding that Letter of Findings are only binding with respect to the taxpayer to whom they are issued, Taxpayer facts are not the same as the taxpayers in the cited Letter of Findings. Therefore, the Department declines the opportunity to address them.

Moreover, Taxpayer's argument that its customers require the labels and therefore the labels become part of the product is not persuasive. While Taxpayer's labels may be required by its customers and/or an essential component within Taxpayer's marketing and distribution process, the labels do not become "material parts" of Taxpayer's products. The labels do not "constitute a material or integral part of the finished product." The labels are not essential to Taxpayer's finished products and do not affect the performance or utility of those finished products. Thus, the labels do not benefit the ultimate consumer. The labels are merely the ancillary means by which the Taxpayer's finished product finds its way to the ultimate consumer. Therefore, Taxpayer has not shown that the labels qualify for the "incorporation exemption" set out in IC § 6-2.5-5-6 and [45 IAC 2.2-5-14\(d\)\(2\)](#).

Taxpayer also asserts that the printer and other labeling equipment used to print the labels are exempt pursuant to [IC 6-2.5-5-3\(b\)](#) because they are directly used in the direct production of the taxpayer's product. However, since the labels have been determined to not be part of the finished product, the permit and printer used in producing the labels do not impact the finished product. Thus, the printer and other labeling equipment are not exempt.

FINDING

Taxpayer's protest is respectfully denied.

III. Sales and Use Tax—Use Tax Paid in Error.**DISCUSSION**

Taxpayer asserts that Taxpayer erred when it remitted use tax on its purchase of catered meals. Taxpayer maintains that Taxpayer does not owe use tax because it paid sales tax at the time of purchase. Taxpayer claims that the price on the invoice included sales tax.

Indiana imposes "an excise tax, known as the use tax," on tangible personal property that is acquired in retail transactions and is stored, used, or consumed in Indiana. IC § 6-2.5-3-2(a). An exemption from the use tax is granted for transactions when sales tax was paid at the time of purchase pursuant to IC § 6-2.5-3-4.

In applying any tax exemption, the general rule is that "tax exemptions are strictly construed in favor of taxation and against the exemption." *Indiana Dep't of State Revenue v. Kimball Int'l Inc.*, 520 N.E.2d 454, 456 (Ind. Ct. App. 1988).

IC § 6-2.5-2-1(b), provides that sales tax "shall" be paid "to the retail merchant as a separate added amount to the consideration in the transaction. The retail merchant shall collect the tax as agent for the state."

However, the invoice provided by Taxpayer is for one single amount and does not show a separately stated sales tax. Thus, Taxpayer did not pay sales tax at the time of purchase. Since Taxpayer did not pay sales tax at the time of purchase, the exemption found at IC § 6-3.5-3-4 does not apply to Taxpayer's purchase.

FINDING

Therefore, Taxpayer's protest is respectfully denied.

IV. Tax Administration—Penalty.

The Department issued proposed assessments for additional use tax due for the tax years in question. Taxpayer protests the imposition of the negligence penalty that is issued pursuant to IC § 6-8.1-10-2.1(a)(3). However, the Department did not assess penalty on the assessments.

FINDING

Taxpayer's protest is respectfully denied.

CONCLUSION

In summary, Taxpayer's protests of Issue I(A), Issue II, Issue III, and Issue IV are denied, and Taxpayer's protests of Issue I(D) and I(E) are sustained. Taxpayer's protests of Issue I(B) and Issue I(C) are denied in part and sustained in part subject to the findings of a supplemental audit.

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